Testimony of Eric Schaeffer
Director, Environmental Integrity Project
Before the House Government Reform Subcommittee on Energy and Resources
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Thank you, Mr. Chairman, for the opportunity to testify today. My name is Eric Schaeffer, and I am Director of the Environmental Integrity Project, a public interest group dedicated to the enforcement of environmental laws. I appreciate your thoughtful efforts to evaluate the adequacy of refining capacity in the United States, and would like to address the following questions in my testimony:

- How much do American consumers have to pay for gasoline before oil companies will increase refining capacity?
- Why have refiners chosen to expand at existing facilities, instead of building new refineries?
- Do environmental rules play a significant role in deterring investment in refining capacity?
- Are government actions more likely to be effective at increasing the supply of gasoline, or moderating demand?

Refiners, like other rational producers, will tend to invest in new capacity when prices are high and profit margins high. As prices moderate and margins shrink, capacity will stagnate or even decline. As is widely reported in the business press, refineries today are enjoying record profits. The top five oil companies have reported a quarter of a *trillion* dollars a year in profits since 2001. While the stock market has

been flat for almost everyone else this year, at least three refiners (Valero, Conoco-Phillips, and Sunoco) have offered stock splits in the last six months. Valero, now the nation's largest refiner, has reported eight successive quarters of record earnings, and Citgo paid its shareholders a $400 million dividend earlier this year.

Not surprisingly, refineries are investing some of this windfall by adding to capacity, but are doing so by expanding existing plants instead of building new refineries. Several large expansions were recently completed, and projects reported or announced to date are expected to add nearly 600,000 barrels of capacity over the next several years. A recent presentation by Marathon-Ashland, one of the country's leading refiners, argues that it makes good business sense to increase capacity at existing plants, instead of building new ones. Expansions allow refiners to take advantage of economies of scale, and to tailor the additional production to specific market needs.

Underlying this business strategy is a recognition that the good times may not last, as prices moderate and margins shrink again. It makes sense, given the historic volatility of the market, to expand incrementally instead of investing in a big new refinery that may not be profitable a few years down the road. That may explain why the proposed new refinery in Yuma, Arizona, is still searching for investors after receiving its environmental permits, while expansion projects continue to multiply.

It is pretty clear that gasoline priced at $3 a gallon makes it economically attractive to add to capacity, at least temporarily. But those same high prices also give consumers an incentive to conserve and reduce their demand. The Department of Energy reports that the demand for gasoline is below last year's levels, and sport utility vehicles are piling up on dealers' lots while consumers join waiting lists to purchase energy-efficient hybrids. Last year, energy analysts at Booz-Allen cautioned refiners that demand for gasoline would "plummet" below supply as early as 2007, if inflation-adjusted prices remained at $2 per gallon (which is well below today's levels). It is important to remember that ten years ago, refiners were complaining that the industry was stuck with too much capacity. For example, a senior energy analyst warned an industry audience at an API convention in the fall of 1995 that, "if the U.S. petroleum industry doesn't reduce its refining capacity, it will never see any substantial increase in refining margins." If demand declines again, we can expect these complaints to resurface.

While there is no question that environmental rules add to the cost of refining, the industry's own testimony suggests that it is not a significant impediment to investments in new capacity. Valero, the nation's largest refiner, has acknowledged "it was the poor margins that had the biggest impact [on refinery capacity], not the environmental rules." Red Cavaney, President of the American Petroleum Institute, testified before Representative Barton's House Subcommittee on Energy and Air Quality last summer that, "We have not said that environmental rules are responsible for the higher prices." Bob Slaughter of the National Petroleum Refiners Association

has advised Congress *against* any further relaxation of clean fuels requirements until additional studies are undertaken, urging Members to, "resist imposition of additional fuel specification changes on top of those already in progress." Indeed, lowering our standards for cleaner fuel could flood U.S. markets with imports of cheap gasoline from countries with lower environmental standards, making investment in refinery capacity in the U.S. even less attractive.

The Environmental Protection Agency's report to the White House in June of 2002 found that Clean Air Act "New Source Review" requirements had "not significantly impeded investment in new power plants or refineries." Permit requirements for modifications at existing plants have already been relaxed by the Bush Administration at the industry's request, so these rules can no longer serve as the whipping boy for lack of capacity.

I would like to point out that the only data we have about the cost of environmental rules comes from the industry itself, through periodic surveys conducted by the American Petroleum Institute. This data has been accepted uncritically for years by government regulators at the Environmental Protection Agency, the Federal Trade Commission and the Department of Energy.

I suspect that some of the costs charged to environmental regulation may be indistinguishable from investments that improve a refinery's productivity and profitability. For example, rules that prohibit leaks of volatile organic compounds

from tanks and valves help the industry recover valuable product that would otherwise be lost. Because the cost of environmental rules are always a hot topic of debate in Congress, I hope you will ask the General Accounting Office to pull back the curtain and undertake a critical evaluation of cost estimates that are now taken for granted.

Of course, the surest way to secure enough gasoline at a reasonable price is to reduce our consumption. In the long run, this may be much more effective than trying to legislate domestic supplies of a commodity, the price of which is driven by the global market. New automotive technologies, even for heavier vehicles, are achieving much higher fuel efficiency without compromising safety. Our fuel efficiency standards are woefully out of date, and small improvements could make a huge difference in bringing the demand for gasoline in line with supply. A recent poll by the Pew Charitable Trusts shows that eighty-six percent of respondents would support tighter fuel efficiency standards. I hope that Congress will find time to consider a solution that the public is so clearly ready to embrace.